No. 22

Supreme Court of the United States

OCTOBER TERM, 1962

UNITED STATES, PETITIONER,

versus

TALBOT PATRICK, *ET AL.*

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR TALBOT PATRICK, ET AL. ON REARGUMENT *

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* This brief replaces the original brief on the merits filed by Robert M. Ward.

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CITATIONS

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QUESTIONS PRESENTED

1. Whether the issues in this case have been determined by the District Court and affirmed by the Court of Appeals as questions of fact.

2. Whether under the facts in this case taxpayer is entitled to a deduction under Section 212 (2) of the Internal Revenue Code of 1954 for legal fees he paid his own and his former wife's attorneys for legal services rendered in connection with negotiation for and transfer and exchange of income producing properties.

This brief ~~replaces the~~ original brief on the merits filed by Robert M. Ward.

STATEMENT

Talbot Patrick, the taxpayer, was sued for divorce by his then wife, Mrs. Paula M. Patrick, on December 16, 1955, in the Court of Common Pleas for York County, South Carolina. The wife sought an absolute divorce on grounds of adultery, court supervision of division of properties, a property settlement, child custody, and attorneys fees. Taxpayer's time to answer was extended. There then followed extended negotiations between counsel for the parties, the most difficult and time-consuming portion being given to reaching agreement on certain business properties (R. 31, 42-43) which had a unique value to both parties. (R. 24, 35, 43.) As a result of these negotiations, a Stipulation and Agreement was entered into April 17, 1956. This was superseded by an Amended Stipulation and Agreement of June 14, 1956. (R. 17-15.) The agreement provided for custody of children, payments by taxpayer for support and maintenance of the children, and for taxpayer and his wife each to take one of the two family residences. It also provided for transfer and exchange of income-producing properties of the parties, as hereinafter shown. Taxpayer did not contest the divorce and did not testify at the hearing. The Court subsequently issued a final decree of absolute divorce, approved the property settlements and exchanges made by the parties, and, by reference, required the payment by taxpayer of all attorneys fees. Counsel for the parties charged fees of $2,000.00 each, or a total of $4,000.00, for handling the divorce and matters incidental thereto. Taxpayer paid the total fee, and no part of this $4,000.00 was claimed as deductible by taxpayer.

Taxpayer was at the time of the divorce action President and Treasurer of the Herald Publishing Co., and editor and publisher of the company's daily newspaper at Rock Hill, South Carolina. He owned 28% of the stock

of the publishing company, the majority of the stock being in his wife (28%), in a son (9%) and in trust for the children (35%). As a result of the negotiations of counsel, taxpayer was able to transfer $112,000.00 in "blue chip" securities to his wife in exchange for her 28% stock. (R. 11.) The $112,000.00 was the fair market value for the stock as determined by offers of purchase at the time. (R. 24.) Taxpayer took the stock subject to a condition that he could not sell it unless such sale was part of a sale of the whole of the company's stock and that in such event he must first transfer the stock to his children who would effect the sale and receive the proceeds. In the event of his death prior to any such sale the stock would pass to his children. For the negotiations which made possible this transfer of properties, and for implementing same, counsel for the parties charged total fees of $16,000.00, which taxpayer paid and claimed as deductible.

Real property leased in part to the publishing company was owned at the time of the divorce by taxpayer (80%) and his wife (20%). As a result of the negotiated agreement, these interests were transferred to a trust with the net income to the wife for life and then to the children. A long term lease to the publishing company was guaranteed by the agreement. The total fees of counsel were $4,000.00, which taxpayer paid. Since his interest in the real property had been 80%, he claimed 80% of the fees, or $3,200.00, as deductible.

The District Court found that the $16,000.00 and the $3,200.00 paid by Talbot Patrick as attorneys fees were deductible as expenses incurred for the management, conservation or maintenance of property held for the production of income. The Court of Appeals affirmed, saying that in view of the findings of fact of the District Court and the undisputed testimony on behalf of the petitioner (tax-

payer, the legal fees in the amount of $19,200.00 paid by taxpayer for the protection and conservation of his income producing property were properly deductible as claimed.

ARGUMENT

Taxpayer verily believes that this case was properly determined by the findings of the District Court, as affirmed by the Court of Appeals. The Courts below cannot be reversed without being reversed on findings of fact.

The expenditures in question were incurred in connection with the management and conservation of income producing properties and were not capital in nature. Although the case was tried in the District Court and Court of Appeals primarily on the Government's theory that the expenses were personal in nature and thus non-deductible, the claim that they approached a capital nature was considered by the courts below and rejected on examination of the facts. Neither were the expenditures personal in nature. personal fees involved in the divorce, custody of and support for children, the disposition of personal residences and matters thus incidental to the divorce were never claimed as deductible.

The fees which were claimed were paid to counsel for extended and complex negotiations which ultimately led to agreement and transfer by taxpayer of securities to his wife in exchange for life control of her publishing company stock; and which led to agreement and transfer of taxpayer's and his wife's interests in business property to a trust, with a long term lease provided for his publishing business.

These fees were not a part of the cost of acquiring property, or resisting liability, nor were they personal in nature, but were, within the meaning of the statute, related

to the management and conservation of income-producing property, and uniquely so under the facts of this case.

Since 1942 there has been provision in the Internal Revenue Code for deduction of some nonbusiness expenses. This was the Congress's solution to the problem of lack of such legislation as emphasized by the case of *Higgins v. Commissioner*, 312 U. S. 212. An examination of the statute and the decided cases makes clear that whether or not an expense is in connection with the taxpayer's trade or business, if it is expended in the pursuit of income or in connection with property held for the production of income, it is allowable. This does not apply to expenses primarily involved in sports, hobbies, or recreation, but does apply when such expenses are ordinary and necessary, reasonable in amount, and bear some reasonable and proximate relation to the production or collection of income or to the management, conservation, or maintenance of property held for that purpose. This on a showing that in this case the attorneys fees taxpayer was required to pay met these tests, the District Court properly held them deductible. In this case the United States has not questioned that the fees were ordinary and necessary expenses and reasonable in amount. The issue grows out of the activity to which the fees related.

I

The trier of fact has determined that attorneys fees here involved bore a reasonable and proximate relation to the management, conservation, or maintenance of property held for income.

In this case the District Court, sitting without a jury, heard all the facts and circumstances and determined that the attorneys fees were expended by taxpayer in the management, conservation, or maintenance of income-producing property.

In Trust of *Bingham v. Commissioner*, 325 U. S. 365, the Tax Court had heard the facts and concluded that legal fees were expended for the management and conservation of income-producing property. The Second Circuit reversed, 145 F. (2d) 568. The Supreme Court granted *certiorari*; and, in reversing the Second Circuit and affirming the findings of the Tax Court, said:

> "* * * Deductible expenses * * * must be reasonable in amount and must bear a reasonable and proximate relation to the management of property held for the production of income. * * * Ordinarily, questions of reasonableness and proximity are for the trier of fact, here the Tax Court. *Commissioner v. Heininger*, 320 U. S. 467; *McDonald v. Commissioner*, 323 U. S. 57, 64-65; *Commissioner v. Scottish American Investment Co.*, 323 U. S. 119. * * * The Tax Court could find as a matter of fact, as it did, that the expenses of contesting the income taxes were a proximate result of the holding of the property for income. And we cannot say, as a matter of law, that such expenses are any less deductible than expenses of suits to recover income."

II

A. Attorneys fees reasonably and proximately related to the management, conservation, or maintenance of property held for the production of income are not personal, living, or family expenses, but are nonbusiness expenses properly deductible under Code Section 212 (2).

In *Lykes v. United States*, 343 U. S. 118, the Court reviewed the whole question of nonbusiness deductions. It cited in particular the House Committee Report:

> "* * * Thus, whether or not the expense is in connection with the taxpayer's trade or business, if it is expended in the pursuit of income or in connection with property held for the production of income, it is allowable * * *. The expenses, however, of carry-

ing on a transaction * * * primarily as a sport, hobby, or recreation, are not allowable as non-trade or non-business expenses. Expenses to be deductible * * * must be ordinary and necessary, which rule presupposes that they must be reasonable in amount and must bear a reasonable and proximate relation to the production or collection of income or to the management, conservation, or maintenance of property held for that purpose * * *" H. R. Rep. 2333, 77th Congress, 2nd Session. To the same effect see S. Rep. No. 1631, 77th Congress, 2nd Session.

In *Lykes*, the ordinary and necessary character of the legal expenses incurred was recognized. Deductibility turned wholly upon the nature of the activities to which they related. And so, as taxpayer sees it, does this case.

Lykes considered a gift tax question. The taxpayer gave away stock with a fixed value and the Commissioner of Internal Revenue revalued it and assessed a deficiency. The fees in that case were incurred in contesting this deficiency or in resisting liability, not as in the instant case, in seeking and finding a legal and acceptable manner for rearranging holdings of income producing property and still conserving income and income producing property. In *Lykes* the Court was faced with the facts and also with Treasury Decision 5513, 23 CFR 29.23 (a)-15 (k) in force since 1946 (to which it gave weight) unequivocally holding that fees in determining gift tax liability are not deductible.

In *Baer v. Commissioner*, 196 F. (2d) 646, the Eighth Circuit Court of Appeals held that "* * * the controversy did not go to the question of liability but to the manner in which it might be met by the petitioner without greatly disturbing his financial structure * * *." The Court allowed $16,500.00 of the husband's attorneys fees as being involved in the maintenance or conservation of property for the production of income.

Fees similarly were allowed on this basis in *Fisher v. United States*, 157 Fed. Supp. 364; and *Allen v. United States*, 56-2 USTC 9867.

In *Bowers v. Commissioner*, 243 F. (2d) 904, (6th C. A.) the Court allowed a $15,000.00 attorneys fees as claimed, with the statement that as in the *Baer case* there was little occasion for lawyer's services in the divorce, that their services were largely devoted to adjustment of the taxpayer's liability to his wife.

In *McMurtry v. United States*, 132 Fed. Supp. 114, the Court of Claims cited *Baer* and gave taxpayer an opportunity to show to what extent legal expenses were incurred in conservation and maintenance of property.

In certain cases attorneys fees have been denied. But they are easily distinguished from the instant case.

In *Harris v. United States*, 275 F. (2d) 238, the Ninth Circuit held that attorneys fees were incurred to resist the wife's claim that there was community property and there was no evidence of the value of the attorneys fees in dividing property. This case, the Court said, was not *Baer*.

In *Tressler v. Commissioner*, 228 F. (2d) 356, the Ninth Circuit cited *Baer* and *McMurtry* but distinguished *Tressler* by saying that the expense of the litigation was incurred to defeat the wife's suit and not to protect the petitioner's property.

In *Howard v. Commissioner*, 202 F. (2d) 28, the Ninth Circuit cites *Baer* with approval but says that Howard's fees involved the defense of the wife's action to collect money awarded her in a divorce action and therefore were not deductible. *Smith's Estate v. Commissioner*, 208 F. (2d) 349; and *Norton v. Commissioner*, 192 F. (2d) 960, can be similarly distinguished.

In refusing to permit deductions, the Fourth Circuit has said in *Richardson v. Commissioner*, 234 F. (2d) 248, that "* * * It is clear that the attorneys for the husband expended no effort in the conservation or maintenance of his property as envisioned by the Statute. * * * Their services were directed to preventing any liability being imposed upon the husband for the wife's support and it is this for which they were paid. * * * Even if any part of the fee paid by him to his attorneys could be said to be for services in conserving his property, no effort has been made to show what part of the sums paid should be allotted to that purpose * * *. Unless and until it is shown what part of the sums paid them are applicable to that part of their efforts there is no basis upon which to grant a deduction * * *. None of the conditions which formed the basis for the decision in the *Baer case* exists in the case now before us."

In *Douglas v. Commissioner*, 33 T. C. 349, the wife was attempting to deduct legal fees incurred in an attempt to secure property in connection with a marital separation.

Donnelley v. Commissioner, 16 T. C. 1196, disallowed deduction of legal expenses paid in resisting a former wife's suit to collect back alimony. This case was decided before the *Baer case*.

In *Lewis v. Commissioner*, 253 F. (2d) 821, the Second Circuit refused to allow attorneys fees on the theory that such fees were spent in resisting legal separation proceedings and liability. But the case was in no way similar to the *Patrick case*.

Judge Waterman did write in *Lewis, supra*, that he could not reconcile *Baer* with *Lykes*; but Judge Lumbard "would limit this discussion to distinguishing *Baer v. Commissioner* on its facts" and he would have allowed expenses in litigation over revocation of an *inter vivos* trust.

All decisions read with the statute and *Lykes* in mind simply bear out that not all attorneys fees are deductible but equally that in certain circumstances they are. A broad rule such as is sought by the Government here would bar relief in proper cases such as the instant one.

The Courts have allowed deduction of attorneys fees in property settlements growing out of divorces where there is a reasonable and proximate relation to production of income or conservation or management of income property.

B. An essential in this case, as in the Baer line of decisions and as outlined in the Lykes case, was that the fees were not expended to resist liability but to find a manner in which it could be met without depriving taxpayer of his income or income-producing property.

Consideration should be given to the question as to whether or not a "threat" to property is the real test in the *Baer* line of cases. It is true that a "threat" appears, but that was the occasion for the expenditures of fees, rather than the justification therefor under the law.

In any event, there was a unique "threat" to both the income and the income-producing property of taxpayer in this case. (R. 31.)

At the time he was sued for divorce, taxpayer was a minority stockholder in Herald Publishing Co. Because of the family unity which had existed, taxpayer had controlled the Herald operations and had been Editor and Publisher of the newspaper and a director and president of the corporation and drew salaries therefrom. With the commencement of the suit against him, his life work and the property which he had built up was a risk. There was the distinct possibility that control of the corporation would be sold, and the wife's attorneys were approached by prospective purchasers.

It was not necessary for his wife to take from him his Herald stock, for taxpayer to be subject to the loss of his salaried position and his only salary income as well as control of the operations to which he had given years of effort and which he had built up. His wife, with her 28% of the stock and as trustee jointly controlling the stock of her children and, with the support of her son Hugh would have controlled the corporation. With family unity broken, this control could have been exercised by the wife to taxpayer's detriment.

It developed in the negotiations that there was a way to meet the wife's claims and to retain control of the publishing business and conserve the property he had built. His wife had independent means and sought generally either to retain her stock control of the publishing business (R. 24) or tie it up so that he could never sell the property. He was not engaged in resisting liabilities, and attorneys fees were not expended for that purpose. The negotiations concerned themselves with the manner in which taxpayer could meet all claims and conserve his income property. This was the immediate purpose of the expenditures of the fees. The United States argues that the agreement between the parties as to the manner of solution shows full accord and harmony between the parties and no risk to taxpayer. In so arguing, Petitioner is ignoring a fact of life: that months of patient negotiation by competent and experienced counsel concerned with the best interests of their clients was necessary to effect the agreement.

The risk and danger to income and specific income-producing property was there until the matter was concluded. And it was not concluded until there was a readjustment of income-producing holdings under which the taxpayer gave up his undivided interest in the building occupied by the newspaper and thus assured that there

would be no partition of this real estate or outside co-owner and no interruption of occupancy of the building, conserving also its income producing potential for the children of taxpayer and his wife. Prior to this agreement, the wife had equal rights to control or block control of the use of this business real estate. (R. 32, 33.)

The matter was not concluded until taxpayer had transferred some $112,000.00 in high quality income producing stocks and bonds in exchange for what amounted to a voting right for life in the wife's stock in the newspaper corporation. The manner of meeting taxpayer's liability in this particular was important in preserving his financial structure. It is implied that there was no overt move to claim taxpayer's stock and that anything else of value would have satisfied the wife's claim and that stocks and bonds did in fact satisfy this claim without disturbing taxpayer's Herald stock. But Mr. Spencer testified that he was convinced that Mrs. Patrick had a definite and special interest in the Herald Publishing Co. stock as such, for reasons shown, and would not in any sense have considered some other blue chip stocks of equal monetary value to be acceptable by way of direct exchange with no limitations. (R. 37.)

Examination then reflects that the essential element outlined in *Lykes* and considered in *Baer* and related cases is present in that the controversy did not go to the question of liability but to the manner in which it might be met without disturbing taxpayer's financial structure.

III

Attorneys fees were not the capital costs of acquiring stock or disposing of real estate but were reasonably and proximately related to the current management and conservation of income-producing properties.

A. The Government cites *Helvering v. Winmill*, 305 U. S. 79, decided in 1938 in connection with the acquisition of stock by Patrick. In that case it was held that taxpayer was in the business of buying and selling securities and would not be permitted to deduct broker's purchase commissions as a business expense on the basis that they constituted a part of the acquisition cost of the securities. The Government also cites *Crowley v. Commissioner*, 89 F. 2nd 715 (C. A. 6) decided in 1937. There it was decided that attorneys fees expended in litigation over alleged mismanagement of a corporation were no part of the ordinary business expense of a trust.

Neither of these cases resembles *Patrick*.

Taxpayer's salary, as he testified (R. 25) was low because of his interest in the newspaper and the building of a good property. It was necessary to his continued income and protection of the value of his income producing stock that he continue his control. So the shifting of other income producing property for that which would assure him a voting control of the corporation and continuance of his positions with the corporation was necessary. These were incidents of management and conservation of income producing property; and this was a part of the necessary expense to him. His income situation was changed by the settlement, so that the newspaper position and property became more important in his total financial situation. He transferred properties which made up the bulk of his other income for properties connected with his business.

None of these facts tend to characterize his expenditures as a part of the capital cost of acquisition of stock. Additionally this Court does not know how many proposals, counter-proposals and efforts were involved before the final solution of transfer of securities for Herald stock was accomplished.

B. In considering negotiation of a long-term lease which assured taxpayer that his publishing business would continue occupying the building in which he had transferred his interest, the Government cites *Deputy v. duPont*, 308 U. S. 488, decided in 1940. The taxpayer's claim for deduction of dividends and income tax paid on borrowed stock was disallowed as not being an ordinary business expense. There the court was concerned with an "extraordinary" situation "beyond the norm of general and accepted business practice" and "so extraordinary as to occur in the lives of ordinary business men not at all" and in the life of the respondent "but once."

(And there appears a dissent by Mr. Justice Frankfurter to the effect that "what the activities of a taxpayer are is for the trier of facts" as is now argued in *Patrick*.)

Petitioner argues at Page 11, Paragraph 2, of its Brief, that "to the extent that the fees were incurred to assure the corporation's right to occupy the premises (*i. e.*, on behalf of the lessee) they should have been paid by the corporation, and respondent's payment of them constituted a contribution of capital to the corporation. Petitioner knows, or should know, that the corporation did pay a part of the attorneys fees and that this was disallowed by the Internal Revenue Service as not being a proper corporate expense. (R. 5.)

Taxpayer's placing of his undivided interest in the business real estate in trust along with the undivided in-

terest therein of his wife was an incident of management and conservation of his income producing property through assurance of income for his wife and children and through protection against division and guarantee of an undisturbed lease for his newspaper. This, too, was the result of negotiations by counsel for which the claimed fees were paid.

IV

Legal fees which taxpayer was required to pay his wife's attorneys were deductible exactly as were those he paid his own attorneys.

Attorneys fees were demanded in the divorce action and required to be paid by taxpayer under the State Court's Final Order. So far as they related to the divorce and the essentials thereof ($2,000.00 to his own and $2,000.00 to his wife's attorneys) they were paid by taxpayer and not claimed as deductible.

But $19,200.00 in fees paid jointly to the attorneys for taxpayer and his wife and attributed to the long negotiations which resulted in rearrangement of the stock and business properties were paid and are claimed as deductible. It was a part of his agreement, necessary to attain agreement, that he pay these fees. And subsequently, the court, in approving the transfer and exchanges of properties, directed by its Order that he pay all attorneys fees.

In contesting this claim, the Government cites *United States v. Davis*, 370 U. S. 65 at 74-75. That recent case in no way resembles *Patrick*. There the fees were for specific tax advice of benefit only to the wife and for services to her. The attorney, it was found, "considered the problems from the standpoint of his client alone. Certainly then it cannot be said that . . . (his) advice was directed to plaintiff's tax problems. . . ."

The facts, as reviewed below, were different as to *Patrick*, and were, in the ordinary practice, unusual. And they were considered in full by the trier of the facts.

Owens v. Commissioner, 273 F. 2nd 251 also was unusual in much the same sense. There the Fifth Circuit permitted deduction of fees paid to the wife's attorney, who also represented the husband, in a property settlement incident to a divorce. The Court set out, as is argued here, that "* * * deductibility turns wholly upon the nature of the activities to which they related * * * We do not think that the fact that the payment was made to the wife's attorney has any determinant force * * * The ultimate and only fact before the Tax Court and before us was and is whether the $7,500.00 was actually paid to the attorney in connection with the saving of the business in which the husband was interested * * *. In other words, the domestic dispute furnished the occasion, but not the motive, for the payment of the $7,500.00 to the attorney."

From the Patrick record it appears that much of the negotiations of attorneys in connection with the property settlement was designed to arrive at a means of permitting taxpayer to retain his control of the newspaper and his offices and employment but to "tie up" and limit his interests in a manner acceptable to his wife. And in this area it appears that there were "almost joint aims" of opposing counsel (although certainly within every bound of propriety).

John H. Lumpkin, counsel for the wife, testified that "I am trying to recollect as precisely as possible, which is the reason for my pause, the background and the reasons for the final stipulation. Certainly in part it was as stated by you, to tie up his interest thereby protecting the children. Certainly in part it was to continue him in active

management of the newspaper and to provide that if he should dispose or could dispose of his interest, the children would be protected, and finally, I think a very cogent reason in these negotiations as culminated in the Stipulation, was to continue him in an income producing status."

He was asked by counsel for the Government: "Mr. Lumpkin, are you speaking of the negotiation as a whole or the aims which you were striving for as Mrs. Patrick's attorney?" and he replied: "I might say these are almost joint aims as between Mr. Spencer as attorney for the Defendant and by me as Attorney for the Plaintiff." (R. 44.)

It is true the Eighth Circuit did not allow the wife's attorneys' fees in *Baer*. But in *Baer* it was argued that $25,000.00 for purchase of a home and $20,000.00 attorneys fees were "periodic payments" to the wife when all the evidence showed this as a lump sum part of a divorce settlement. There was no claim or finding of fact that the fees were related to the conservation of income producing property. The present (*Patrick*) case makes no attempt to deduct the elements of the settlement on taxpayer's wife nor does it claim that the attorneys fees were part of "periodic payments" to her. It poses the question as coming within the thinking of the *Lykes* case: That the fees were reasonably and proximately related to the management, conservation and maintenance of income producing property.

In *Norton*, *Richardson*, and *Lewis*, all examined herein above, the wife's attorneys fees were not allowed. But the question here posed was not answered there since none of the fees was allowed. It would follow that if the attorneys fees, because of the activities to which they related, were not deductible as to the husband's attorneys, they would not be deductible by him as to the wife's attorneys.

The Government cites *Welch v. Helvering*, 290 U. S. 111, decided in 1933, which simply held that the voluntary payment of debts of a bankrupt firm in order to gain good will was not an ordinary expense of the operation of a business. And it cites *Magruder v. Supplee*, 316 U. S. 394, which did not allow as deductible expenditures in payment of the personal liability (a tax lien) of a predecessor in title; and *Interstate Transit Lines v. Commissioner*, 319 U. S. 590 which disallowed payment of a deficit for a subsidiary business. These cases are too remote to affect the right of the taxpayer to avail himself of the "legislative grace" of a deduction for expenditures made by him in the circumstances of this case.

The only test under the Statute is that the fees be expended in a transaction reasonably and proximately related to the production or collection of income or the conservation, management, or maintenance of income-producing properties. If they were so expended, then they are deductible no matter to whom they were paid. And, on the facts, it was found in the courts below that they were so expended and were deductible.

CONCLUSION

The judgment of the Courts below should be affirmed.

Respectfully submitted,

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Rock Hill, South Carolina,
November, 1962.